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May 8, 2023

Via Email (rule-comments@sec.gov)

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

RE: Safeguarding Advisory Client Assets; Release No. IA-6240; File No. S7-04-23

Ladies and Gentlemen:

The Bank of New York Mellon Corporation ("**BNY Mellon**") appreciates the opportunity to provide comments to the U.S. Securities and Exchange Commission ("**Commission**") in response to the Commission's proposed new Rule 223-1 ("**Proposed Rule**") under the Investment Advisers Act of 1940 ("**Advisers Act**"), which would replace current Rule 206(4)-2 ("**Custody Rule**") and make related changes to Rule 204-2 governing investment adviser books and records, and Form ADV (collectively, the "**Proposal**").[1]

Established in 1784, BNY Mellon is America's oldest bank and the first company listed on the New York Stock Exchange (NYSE: BK). BNY Mellon is a global systemically important bank[2] ("**G-SIB**") that powers capital markets around the world through comprehensive solutions that help clients manage and service their financial assets throughout the investment life cycle. BNY Mellon had $46.6 trillion in assets under custody and/or administration ("**AUC/A**") and $1.9 trillion in assets under management as of March 31, 2023.[3] BNY Mellon touches around 20% of the world's investable assets.[4] It is through this ecosystem-wide lens that we view the Proposal and form our comments.

The Proposal, unless adjusted, will directly and fundamentally impact day-to-day operations of our business segments across multiple lines of businesses, which will, in turn, affect the efficiency of global financial markets. Although we participated in trade association responses to the Proposal,[5] this response (**"Response**") is intended to supplement them with our specific views on topics of critical importance to BNY Mellon, its customers, and its clients**.**

While BNY Mellon understands and supports the Commission's articulated objective in the Proposal to enhance the rules concerning the safekeeping of investor assets, we have significant concerns with the breadth of the Proposal. Our general view is that, on balance, the existing Custody Rule is achieving its purpose of preventing client assets from being lost, misused, stolen, or misappropriated.[6] As the Custody Rule was last amended in 2009, we acknowledge that certain *incremental* amendments may be appropriate to enhance investor protections and provide clarity to advisers, custodians, and investors. The Proposal, however, goes further than that. By its own terms, the Commission acknowledges that key provisions in the Proposal represent a "substantial departure from current industry practice," a "substantial expansion" of custodial obligations, and impose contractual requirements that are otherwise "rare."[7] We do not believe that the existing Custody Rule is functioning in a manner that necessitates "substantial" amendments, nor do we believe that a rule regulating *investment advisers* should have the

BNY MELLON

effect of fundamentally redesigning how bank custodial services are provided by upending decades of historical practice in how banks treat client cash.

We are also concerned that the structural changes resulting from the Proposal are in direct conflict of the Commission's mandate to maintain fair, orderly, and efficient markets.[8] By its own terms, the Proposal acknowledges that it could have a negative impact on that mandate.[9] Based on the nature and scope of the Proposal, investor costs have the potential to increase significantly. Furthermore, service provider diversity may diminish as providers may eliminate services or otherwise choose to exit global markets as a result of the burdens imposed by the Proposal, reducing investors' access to services and limiting their investment opportunities. The Commission should more fully justify the substantial costs that custodians, advisers, and ultimately investors will be forced to bear,[10] and the result those costs may have on the availability and competitiveness of the services offered by custodians.

We encourage the Commission to take a multi-step approach to modernizing the Custody Rule:

- First, because of the direct and significant implications of the Proposal, **we encourage the Commission and all of its relevant Divisions and Offices to continue to engage with market participants who will be impacted by the Proposal** and allow them an opportunity to provide meaningful feedback to assist the Commission in consideration of reasonable alternatives. We include in this Response our specific feedback and recommendations as they relate to custody of both traditional and digital assets.[11] A one-page summary of our feedback and recommendations is included in the Appendix (Page 20).

- Second, the Proposal acknowledges that banks are already subject to robust prudential regulation with respect to their custodial services,[12] and **we suggest that the Commission coordinate an interagency working group with federal and state banking regulators and the Department of Treasury** in order to promote regulatory coordination and alignment. This interagency working group can also address important policy questions raised in the Proposal. For example, whereas the Proposal seeks to protect certain deposits in the event of the insolvency of the custodian, the Federal Deposit Insurance Corporation ("**FDIC**") is separately assessing preliminary options for deposit insurance reform.[13] Establishment of an interagency working group will prevent regulatory arbitrage.

- Third, in response to the feedback and recommendations received, as well as the output of the interagency process, **we recommend that the Commission either re-propose the Proposal in its entirety, or, at the very least, provide supplemental information and re-open the comment period**. There are significant areas of the Proposal that would benefit from supplemental information and explanation, and the Commission has recently supplemented and re-opened other proposals. For example, on April 14, 2023, the Commission provided supplemental information to its proposed amendments to the definition of "exchange" under the Exchange Act and re-opened the comment period to "help address comments on the proposal from various market participants."[14] Further, on April 28, 2023, the Commission provided supplemental data and analysis related to its proposed amendments to modernize the rules governing beneficial ownership reporting and also re-opened the comment period.[15] We believe the Commission should take similar additional steps here given the Proposal's complexity and broad changes to existing market practices and arrangements.

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Executive Summary

BNY Mellon is uniquely situated to provide direct feedback to the Proposal given the role we play in the market in providing custodial services for traditional assets (as the world's largest custodian by AUC/A) and digital assets (as the first G-SIB to provide custody of digital assets). We do not attempt to address in this Response each and every aspect of the Proposal, nor could we meaningfully address the 286 questions included therein within the 60-day period set by the Commission. We instead focus and streamline this Response to provide thematic feedback and address those provisions of the highest concern and priority to us, as a supplement to the responses to the Proposal submitted by the trade associations.[16] This Response is primarily from the perspective of our Asset Servicing and Digital lines of business that service registered investment advisers ("**RIAs**").

Our concerns are the result of following key changes in the Proposal from the current Custody Rule:

- *Definition of Qualified Custodian*: The Proposal does not alter the four types of institutions that can serve as qualified custodians (bank or saving association; registered broker dealer; registered futures commissions merchant, or certain foreign financial institutions).[17] However, the Proposal adds an additional condition that banks must satisfy in order to meet the definition of a qualified custodian.[18]

  > A qualifying bank or savings association would be required to hold client assets in "an account in which client assets are easily identifiable and clearly segregated from the bank's assets" in order to qualify as a qualified custodian.[19]

  This segregation condition within the Proposal does not distinguish client cash from client securities and other assets. If this segregation condition applies to client cash, this would mark a fundamental shift in how bank custodians treat client cash, reshape the balance sheets of bank custodians, and have significant micro and macro implications. This would represent a comprehensive change in the regulation of prudentially regulated banking entities through a Commission rule focused on investment advisers. **We recommend the Commission exempt client cash held by regulated banking organizations from this new segregation requirement. In an effort to provide enhanced information to investors, the Commission should instead provide a framework to develop certain disclosures to make available to clients regarding cash balances, cash accounts, and the benefits and risks associated with maintaining cash balances at a qualified custodian that is a banking organization.**

- *Minimum Custodial Protections*: The Proposal attempts to set "minimal custodial protections" that are "designed to expand and formalize the standard of protections to advisory clients' assets held by qualified custodians."[20] To do so, the Commission has proposed to construct a new compulsory framework pursuant to which investment advisers would be obligated to legislate, administer and supervise the bilateral relationship between the adviser's client and the client's custodian. By commanding investment advisers to procure "assurances in writing," the Proposal would mandate that parties who have not historically been in contractual privity, enter into a contract that contains new, specified contractual provisions that would supplant critically important terms of the existing contractual relationship between the client and the custodian. These requirements are arbitrary and fail to recognize that the parties are subject to fundamentally different regulatory regimes. **We recommend the Commission reconsider these requirements in light of existing market practices, to avoid punitive impacts, and to preserve the freedom of contract amongst private, sophisticated parties.**

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- *In-Scope Assets*: The Proposal expands in-scope assets from "client funds and securities" under the existing Custody Rule to "funds, securities, *or other positions held in a client's account*"—the expansion of which is intended to capture digital assets.[21] While we appreciate the Commission setting forth the requirements a bank must satisfy in order to serve as a qualified custodian for digital assets, the Proposal conflicts with SEC Staff Accounting Bulletin No. 121 ("**SAB 121**"). On the one hand, the Proposal invites custodians to develop "innovative safeguarding procedures"[22] for digital assets and sets a pathway for banks to do so in a manner that mitigates the risks on which SAB 121 is premised. On the other hand, banks cannot practically serve as qualified custodians for digital assets in any sufficient scale if they are *still subject to* the threshold limitations of SAB 121 by function of requiring custodied digital assets to be reflected on their balance sheets. **We recommend that bank qualified custodians be exempt from the on-balance sheet requirements of SAB 121 in order to resolve this conflict.**

Accordingly, our Response is divided into three parts:

- *Part I – Background on Bank Custodians and Initial Thematic Feedback (Page 5)*: We provide the foundational background on the core custody services bank custodians provide. We explain how clients of bank custodians are generally institutional (not retail) investors, and how bank custodians serve only in an intermediary or facilitator role. We therefore highlight how the Proposal is overbroad in that it (A) seeks to provide enhanced protections for retail investors, but its requirements also apply to institutional investors who are not similarly situated to retail investors; and (B) improperly refers to bank custodians as "gatekeepers" despite the fact that they are only one actor in a wider cast.

- *Part II – Concerns Related to Traditional Custody (Page 6)*: We address (in order of most critical) the top four provisions of concern in the Proposal as they relate to "traditional" custody (*e.g.,* custody of all assets other than digital assets). Those areas of concern are derived primarily from two of the key changes in the Proposal previously described (definition of qualified custodians and minimum custodial protections), and we specifically focus on: (A) segregation of cash; (B) treatment of liability for depositories and sub-custodians; (C) indemnification; and (D) the requirement that written agreements specify the investment adviser's level of authority to effect transactions in the custodial account, including any applicable terms or limitations or the imposition of contractual terms between advisers and custodians. For each of these topics, we (1) explain current practices, (2) describe the impact on BNY Mellon and the broader financial market if the Proposal is adopted as proposed, and (3) make recommendations as to how to narrow each provision to represent incremental amendments to the Custody Rule.

- *Part III – Concerns Related to Digital Asset Custody (Page 17)*: We address concerns in the Proposal as they relate to digital asset custody, focused on outlining the practical conflict between the Proposal and SAB 121. We explain why that conflict must be resolved in order for banks to have the ability to *actually* serve as qualified custodians for digital assets.

BNY MELLON

Part I – Background on Bank Custodians and Initial Thematic Feedback

Bank custodians offer multiple services, including "core custody services": the safekeeping of client assets and record-keeping services, asset servicing, transaction processing and settlement, and banking services.[23] Banks have been providing these safekeeping services for decades—if not centuries, like BNY Mellon—evolving from holding physical assets in their vaults, to an electronic book-entry notation representing shares held through central securities depositories,[24] to most recently custodying assets that are natively-issued on distributed ledgers like blockchain.[25] While it is true that some of these core custody services can be provided by non-banks, bank custodians are differentiated by the fact that they are subject to robust prudential regulation, ongoing supervision and examination, and a comprehensive enforcement regime.[26]

The core custody services provided by large bank custodians result in a fundamentally different business model and customer base than commercial banks. For example, BNY Mellon's main clients are investment companies, asset managers, financial institutions, corporations, central banks and sovereigns. Only certain of our lines of businesses serve retail clients. This is an important foundational difference given the Proposal's repeated focus on the purported limited bargaining power of retail investors.[27] While the Proposal seeks to enhance protections for retail clients, it legislates "one-size-fits-all" requirements that *all* qualified custodians are to provide *irrespective* of whether their client types are institutional-based and not similarly situated to retail clients. This illustrates at the outset the overbreadth of the Proposal.

Further, it is critical to highlight that the core custody services offered by bank custodians represent just one tier in the multi-tiered system for safekeeping, clearing, and settlement.[28] A primary role of a bank custodian is to act as an intermediary between, on the one hand, the client that invests in securities and other investment assets on a proprietary basis and, on the other hand, the financial market utilities that provide the necessary financial market infrastructure to clear and settle transactions in, and act as the ultimate holders of, the investment assets.[29] In this role, bank custodians facilitate client access to and participation in global financial markets, including interactions with other market participants[30] such as the settlement, safekeeping, and reporting of customers' marketable securities and cash.[31] They provide these services to, among others, mutual funds and investment managers, retirement plans, bank fiduciary and agency accounts, bank marketable securities accounts, insurance companies, corporations, endowments and foundations, and private banking clients.[32]

It is with this overall context that we disagree with what appears to be a core premise of the Proposal's new requirements: that custodians, including bank custodians, serve an elevated role—*e.g.,* the Proposal repeatedly refers to custodians as "gatekeepers."[33] While custodians do play an important role in global financial markets, their historical role is based on a contractual allocation of rights and responsibilities with other participants whom themselves are similarly governed by their own contractual arrangements in this multi-tiered system. The Proposal's analogy of custodians to gatekeepers is an overstatement and a misplaced means to achieve an end goal of protecting retail clients by imputing heightened and disproportionate roles and responsibilities to *all* custodians.

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Part II – Concerns Related to Traditional Custody

This part describes four of our specific concerns with the Proposal as a qualified custodian for assets other than digital assets. We have distinct views on the Proposal as it relates to digital assets, which are separately addressed in Part III.

A. Segregation of Cash

Our first and most serious concern with the Proposal relates to the manner in which it would fundamentally transform the way in which a bank custodian holds client assets in the form of cash. The Proposal appropriately maintains from the Custody Rule the eligibility of banks as one of the four types of institutions that may serve as qualified custodians but adds new requirements a bank must satisfy in order to qualify as a qualified custodian.[34] According to the Proposal, a qualifying bank or savings association must:

> hold client assets in an account that is designed to protect such assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association (*i.e.,* an account in which client assets are easily identifiable and clearly segregated from the bank's assets) in order to qualify as a qualified custodian.[35]

This segregation condition does not distinguish client cash from client securities and other assets. While bank custodians can—and do—custody client securities and other non-cash assets in segregated accounts, the same is not true for client cash. Bank custodians treat virtually all cash as an unsecured deposit liability and, as such, the proceeds of that cash are available for redeployment by the custodian bank to, among other things, purchase or originate bank eligible investments. This transformation is central to and necessary for the business of banking. **The Proposal should exempt client cash placed with a bank custodian from this new segregation requirement. Additionally, the Commission should provide a framework to develop certain disclosures to make available to clients regarding cash balances, cash accounts, and the benefits and risks associated with maintaining cash balances at a qualified custodian.**

1. **How Client Cash is Currently Treated**

The provision of "core custody services" results in the operation of separate accounts: (1) one that holds securities and other non-cash assets; and (2) another that holds cash.[36] When a bank custodian custodies client securities and other non-cash assets, these assets are not recognized on the bank custodian's balance sheet. That is because they are not property of the bank custodian—instead, they "remain the property of the beneficial owners and are recognized on the balance sheet of the beneficial owners."[37] Because client securities and other non-cash assets do not become property of the bank custodian, the bank custodian cannot use them for proprietary purposes. Client securities and other non-cash assets therefore comprise the bank custodian's AUC/A, an off-balance sheet measurement. These off-balance sheet client custody assets are held in segregated accounts at the custodian in a manner designed to, among other things, insulate them from the risk of the bank custodian's insolvency.

Client cash is treated in a different manner. **It is a well-established and long-standing principle that "like any cash deposit with a banking institution, the cash held at a custodian becomes the property of the bank and can be used by the bank for its own purposes."**[38] This means that when a bank custodian receives client cash, the bank custodian books (i) a liability on its balance sheet reflecting the depositing client's contractual claim to the return of the cash and (ii) corresponding assets reflecting the assets in

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which the custodian has invested the client cash.[39] The difference in treatment between client securities and non-cash assets versus client cash is one reason why BNY Mellon has $46.6 trillion of AUC/A, but its balance sheet reflects $425 billion in total assets at March 31, 2023.[40] This is also, in part, why of BNY Mellon's $384 billion in total liabilities, $281 billion (73%) is deposit liabilities.[41]

Although client cash is generally held in the bank's omnibus account and not segregated, client deposits receive the benefit of various regulatory protections. First, client cash deposits are insured up to $250,000 per depositor, for each account ownership category by the FDIC. Second, BNY Mellon, like all U.S. banks, must meet a range of capital requirements to ensure it has an adequate buffer against insolvency. As a bank holding company and G-SIB, BNY Mellon is also required to meet the most stringent enhanced prudential standards issued pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act.[42] Among these extensive requirements, BNY Mellon conducts enterprise-wide stress testing, which considers our lines of business, products, geographic areas, and risk types, incorporating the results from underlying models and projections for a range of stress scenarios.[43] Other elements of the safety and soundness regime applied to BNY Mellon include liquidity requirements, counterparty limits, risk management and governance, financial stability requirements and capital requirements that include higher capital ratios to potentially absorb unforeseen losses.[44] These requirements are designed so that banking organizations have adequate capital given the risk levels of their assets and off-balance sheet exposures.

2. General Concerns with the Proposal's Requirement to Segregate Cash

Our concerns with the Proposal here are significant and cannot be overstated: **requiring bank custodians to hold client cash in segregated, off-balance sheet accounts represents a fundamental shift in the historical practice of how bank custodians treat client cash**. While we understand that the goal of the Proposal is to increase the certainty of the return of client cash in the event of a bank custodian's insolvency,[45] requiring cash to be held in the manner suggested has severe implications that outweigh this intended goal and would even disadvantage those investors the Commission seeks to protect.

Bank custodians like BNY Mellon have billions of dollars of client cash on deposit (and therefore on their balance sheet). If client cash is to be held in segregated, off-balance sheet accounts, a multitude of complex, far-reaching consequences will result, the full extent of which are beyond the scope of this Response and are addressed in responses submitted by the trade associations.[46] In general terms, we believe segregation of cash would, at a minimum, result in the following:

- *Materially Limit Bank Liquidity and Disrupt Financial Markets*: Segregating cash off balance sheet could lead banks to turn off intraday credit to impacted custody clients, which would include eliminating the practice of contractual settlement tied to securities-related transactions. As a result, clients might choose to leave a significant amount of cash on deposit overnight with their custody banks to assist in the securities settlement process. Since the banks could not earn any net interest income versus these deposits, they would not pay any interest on them, which could result in a large opportunity loss for impacted clients. Alternatively, clients could choose to fund settlements on an intra-day basis either by (i) securing committed facilities with their custodial banks or (ii) moving cash across various banks (leading to increased operational and settlement risk). Critically, all of these alternatives would lead to increased costs and/or lost income that would downstream negatively impact end clients, including retail clients and pension funds—the very clients the Commission seeks to protect.

- *Sophisticated Investors Preferred*: The Proposal seeks to protect cash deposited with bank qualified custodians that exceed $250,000 (the FDIC limit). Context is important, as those are cash deposits by investors *who utilize an RIA*. Consider two scenarios. A sophisticated investor (a high-net-worth individual or an entity like a hedge fund) uses an RIA and places a $10 million deposit with Bank X, versus a retail investor who has on deposit his or her family's life savings of $300,000 with that same bank, Bank X. In the event Bank X goes insolvent and commences bankruptcy proceedings, the Proposal's cash segregation requirement means that the sophisticated investor is guaranteed to receive back its entire $10 million deposit, but the retail investor is only guaranteed to receive back $250,000 (with the remaining $50,000 representing an unsecured claim in the bankruptcy proceeding). Whereas the Proposal seeks to protect retail investors, those individuals or entities who can afford to utilize an RIA will receive protections *greater* than those who do not.

The Proposal is silent on these consequences.

3. Additional Concerns with the Proposal's Requirement to Segregate Cash

We are also concerned with the underlying basis on which the Proposal's cash segregation requirement is premised. First, although the Proposal mentions the utilization of so-called "special" deposit accounts in a footnote to its discussion of the "relationship between the bank and depositor,"[47] it does not elaborate on special deposit accounts, including why the Proposal relies upon them, how bank custodians are to use them to satisfy this new segregation requirement, or what protections they ultimately provide. On the last point, there is limited regulatory guidance on special deposit accounts, and it remains unclear how the FDIC or other bank regulators treat such accounts in the receivership settlement process. In other words, the Proposal does not establish that special deposit accounts even achieve the desired bankruptcy protections. Analysis of these considerations is critical because while special deposit accounts do technically exist, they are seldomly used in practice. Simply put, the Proposal has not established why or how these accounts are an appropriate solution to the Commission's goals.

Second, there are references in the Proposal suggesting that this requirement is purportedly mirrored from Rule 15c3-3 under the Securities Exchange Act of 1934 ("**1934 Act**"), often referred to as the "Customer Protection Rule,"[48] which regulates a broker-dealer's use of customer securities and funds.[49] We take issue with this comparison insofar as it relates to custodial banks. Rule 15c3-3 and its progeny of proposing and adopting releases has recognized, and in fact accommodated, the notion that cash deposited at custodial banks is not segregated from the proprietary assets of the bank (and allows investment in qualifying assets). For example, in adopting amendments to Rule 15c3-3 in 2013, the Commission explained:

> While cash deposits at a bank are fungible and may be used by the bank in its lending and investment activities, [the rule] requires that a broker-dealer obtain a written contract from the bank wherein the bank agrees not to re-lend or hypothecate securities deposited into the reserve account…*Cash deposits, however, may be freely used in the course of the bank's commercial activities*.[50]

This was restated in 2019 with the adoption of securities-based swap rules, in which the Commission recognized that "deposits … become part of the assets of the bank and can be used by the bank for any of its business activities."[51] We are unaware of any precedent by the Commission—or other regulator—that requires client cash to be treated in the manner outlined in the Proposal.

BNY MELLON

4. Recommendations

As a procedural matter, we reiterate our recommendation for the Commission to convene an interagency working group to conduct economic analyses and other assessments of the impact of requiring cash deposits to be held in segregated, off-balance sheet accounts. The Proposal does not contain any such analyses or assessments, and other regulators and agencies should be involved in those processes given the breadth of the impact and their corresponding goals to maintain the stability of the financial markets. Moreover, this interagency working group (to include the FDIC) can also collectively work to address policy questions (such as those related to the insuring deposits) and practical considerations (such as the nature and extent of "special" deposit accounts). Convening this interagency working group will assist the Commission in carrying out its statutory mandate under the Advisers Act to consider the promotion of efficiency, competition, and capital formation when considering a new rule like the Proposal.[52]

As a substantive matter, we recommend:

- **Client cash be excluded from the Proposal's segregation requirement** for a bank to be a qualified custodian.[53]
- In an effort to provide enhanced information about how client cash is treated, we suggest the Commission should develop a framework, in concert with peer regulatory authorities, that would require disclosure documents be provided to clients which set forth how cash balances are treated and the protections cash may (or may not) be afforded.[54] Thus, while cash will be excluded from the Proposal's segregation requirement, these disclosures will allow investors to make more informed decisions about depositing cash at a qualified bank custodian and fulfills, in an incremental manner, the Commission's goal of "enhanc[ing] transparency in private markets."[55]

B. Treatment of Liability for Depositories and Sub-Custodians

Our second concern with the Proposal relates to the requirement that an adviser obtain assurances in writing from a qualified custodian "that the existence of any sub-custodial, securities depository, or other similar arrangements with regard to the client's assets will not excuse any of the qualified custodian's obligations to the client."[56] As a threshold matter, this is a broad requirement that does not explicitly address or recognize the structural differences between sub-custodians and depositories in the U.S., nor how widely the regulatory regimes among sub-custodians and depositories may vary in off-shore jurisdictions. We believe it is critical to recognize these well-established distinctions. **The Commission should exclude all depositories and foreign sub-custodians and remove the reference to "other similar arrangements" from this aspect of the Proposal.**

1. Current Practice

As we discuss in Part I, the custodian acts as an intermediary between the client that invests in securities and other assets, and financial market utilities that provide the necessary infrastructure to clear and settle transactions and that act as the ultimate holders of those assets. Central securities depositories are the primary example, and in virtually every market, participation in that market's securities depository is available only to local member institutions.

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a. Depositories

First, as is the case with most foreign depositories, use of a securities depository in the U.S. is essentially a consequence of the adviser's (or its client's) decision to invest in securities that are immobilized in that depository. While it is, in theory, possible to hold some types of securities in physical form, as a practical matter, the vast majority of investments in publicly traded securities are held through book entries at a securities depository or, with respect to fund investments, on the books of a transfer agent. For example, if an investor elects to purchase a security that trades on the New York Stock Exchange, that security will be held by the Depository Trust Company ("**DTC**"), and the investor's interest in the security will be reflected on the books of its custodian and other intermediaries. In essence, use of DTC is akin to use of a public utility and is not subject to the control of its participants or of the beneficial owners of securities held by DTC. While U.S. securities depositories are regulated by the Commission as clearing agencies under Section 17A of the 1934 Act, the nature of a depository's internal controls, and other aspects of its operations, **are not open to negotiation between an adviser's client or its custodian and the depository**.

Similarly, qualified custodians do not typically "delegate" custodial responsibility to foreign securities depositories; rather, **use of depositories is driven by the client or adviser's decision to invest in a particular market**. Foreign depositories are often governmental or quasi-governmental entities with which it is seldom possible for a participant to negotiate the terms and conditions under which the assets are held. Indeed, the Commission has long recognized that, unlike foreign sub-custodians, depositories provide a necessary service for which no feasible alternative may exist, that depository standards vary from one country to another, that information about quasi-sovereign depositories may be more difficult to obtain than information about other foreign custodians, and that inflexible depository rules may not accommodate the contract terms or equivalent.[57]

b. Foreign Sub-Custodians

U.S. bank custodians that maintain global networks to support investor decisions to invest in foreign markets ("**Global Custodians**") select local sub-custodians in those jurisdictions after careful vetting. Each foreign market has different exchanges, regulations, and settlement conventions.[58] A Global Custodian's network of sub-custodians in relevant local markets is crucial to provide efficient securities settlement and asset servicing for customers, as well as valuable information on the local markets, including the securities settlement systems, market conventions, and the regulatory environment.[59] Although Global Custodians typically select one or more sub-custodians in a particular country after conducting due diligence, **the decision to enter a market is driven by the customer's desire to invest there**.[60]

Global Custodians provide access to a wide variety of foreign markets ranging from the mature markets of Western Europe to the emerging markets of Eastern Europe and Africa. Investment in a foreign market involves various risks, some of which relate singularly to a particular local custodian within that market—*e.g.*, the practices, procedures and financial strength of the local custodian ("**custodial risks**"). In addition, maintenance of assets overseas exposes an investor to systemic risks that may affect the ability of any local custodian to safeguard assets in that country—*e.g.*, a country's inefficient settlement practices constitute a risk of investing in that country, regardless of the level of care that can be provided by any local custodian ("**country risks**"). Once a decision has been made to invest in a country, prevailing country risks cannot be avoided, except by maintaining assets outside of the country—an alternative that is often not possible or practicable.

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c. Regime for Registered Investment Companies

Section 17(f) of the Investment Company Act of 1940 (the "**1940 Act**") and the Commission rules thereunder provide an established, comprehensive regulatory regime for the custody of registered *investment company* assets.[61] Section 17(f) of the 1940 Act sets out custody requirements for investment companies: a registered fund is required to maintain strict custody of fund assets to protect shareholders from fraud or theft. Custody under Section 17(f) is nearly always accomplished through maintenance of assets with a U.S. bank custodian.[62] An exception to this requirement is provided by Rule 17f-4, which permits banks to relinquish custody to "securities depositories" (*i.e.*, clearinghouses and other central registers for securities) in the U.S. while portfolio securities are in the process of being cleared and settled.[63]

For non-U.S. assets, Rule 17f-5 permits funds to maintain such assets with "eligible foreign custodians" (*i.e.,* local sub-custodians in the off-shore jurisdiction). Under the rule, the fund's board is permitted to delegate its foreign custody responsibilities, but must: (i) determine that it is reasonable to rely on the delegate to oversee the placement of the foreign assets with the sub-custodian; (ii) require written reports from the delegate concerning the fund's custodial arrangements and updates on any material changes; and (iii) obtain the delegate's agreement to exercise at least the level of reasonable care, prudence, and diligence as a person having the responsibility for safekeeping the foreign assets would exercise. Finally, Rule 17f-7 establishes standards for foreign clearinghouses and permits a fund to utilize an "eligible securities depository."[64] Under this rule, a fund's contract with its Global Custodian must require the custodian to give the fund or its manager an initial risk analysis before investing through a particular clearinghouse, continuously monitor the risks associated with that clearinghouse, and provide notice of any material changes in these risks.[65]

2. Concerns with the Proposal's Requirements

We are concerned that the Proposal disregards structural differences between depositories and sub-custodians. In particular, use of a securities depository is a consequence of an investor's decision to invest in securities in a particular market; **there is no separate decision to select the depository and little or no element of choice on the part of a custodian**. Any contractual requirements mandated by the Commission that impose liability on a custodian arising from use of a depository should recognize this fundamental premise. If a domestic securities depository is not conducting its operations in a safe and professional manner, a custodian cannot remedy the situation, by contract or otherwise. To the contrary, the Commission has plenary authority over the rules governing the activities of registered clearing agencies; is empowered to inspect such facilities to assure compliance; and may revoke the registration of any clearing agency that fails to adhere to Commission requirements. If the Commission wished to "expand and formalize the standard of protections to advisory clients' assets" in a manner that would "provide consistent investor protections,"[66] it should do so directly, not by interposing qualified custodians to incur liability for activities in which it has no structural ability to mitigate.

The same concern applies to foreign depositories, where the use of a depository is fundamentally a prerequisite for participation in a particular foreign market—a decision exclusively held by the investment adviser or its client.[67] The intrinsic relationship between a foreign investment market and that market's central securities depository is well-established. The Commission has previously examined this issue at various points between 1995 and 2000 when it amended Rule 17f-5 (regulating use of foreign custodians by investment companies) and proposed and adopted Rule 17f-7 (regulating use of foreign securities

depositories by investment companies) under the 1940 Act.[68] In 1995, the Commission recognized that maintenance of assets overseas exposes an investor to systemic risks that "may affect the ability of any custodian to safeguard … assets in that country …. For example, a country's inefficient settlement practices constitute a risk of investing in that country, regardless of the level of care that can be provided by a particular custodian."[69] In 1999, the Commission acknowledged that the decision to maintain assets with the depository remains closely linked to the decision to invest or continue to invest in a particular country and therefore proposed Rule 17f-7 after determining that the application of Rule 17f-5's foreign custody standards to foreign depositories was utterly unworkable.[70] In other words, the Commission understood that use of the central securities depository by one or more of its local participants is an aspect of this country risk; a relationship that still exists today and which the Proposal ignores.[71] The Proposal should not, therefore, be predicated on the fiction that qualified custodians "select,"[72] "hire,"[73] "delegate,"[74] "outsource,"[75] or make the ultimate decision to use, or to refrain from using, a particular securities depository.

With respect to foreign sub-custodians, the Proposal makes no distinction between custodial risk, which would largely (but not exclusively) be based on the particular sub-custodian in a given foreign investment market, and all other systemic, geopolitical, economic, structural and market risk that exists regardless of the level of care that can be provided by a particular custodian in that market. The Commission itself has recognized the decision to expose client assets to "systemic risks" in foreign jurisdictions are "inherently a part of the investment risks associated with the decision to invest in a particular country and should be considered by [investors] or [their] investment adviser before [investing] in a foreign country."[76]

In fact, the Commission eliminated in the 1997 amendments to Rule 17f-5 the consideration of "prevailing country risks," *i.e.*, risks associated with investing in a particular country rather than placing assets with a particular custodian, as well as the consideration of other investment risks. Those amendments distinguished between the "custody risks" of maintaining assets overseas, which must be addressed by a fund's foreign custody manager, and "prevailing country risks," which no longer had to be considered under the rule.[77] The Commission made these changes after concluding that prevailing country risks were akin to investment risks, and that both should be considered by a fund's board or investment adviser when deciding whether the fund should invest in a particular country.[78]

Institutional and other sophisticated investors understand and choose to assume such risks, particularly in frontier and emerging markets. The Proposal would result in a qualified custodian bearing the full spectrum of investment risks on behalf of its clients whenever adviser client assets are held with a foreign sub-custodian and, in so doing, undercut the well-established disclosure regime applicable to investment products. Because of this, we believe it is appropriate for Global Custodian to continue to use reasonable care in the selection, retention, and monitoring of its sub-custodial network as well as continue to make available information regarding the financial markets in which it operates including the "financial systems and practices of foreign markets."[79]

Finally, the Proposal's reference to "*other similar arrangements*" is broad, unclear and creates uncertainty as to the scope and types of arrangements to which the qualified custodian would be expected to remain liable without qualification.[80] The Proposal provides no examples or explanation regarding the "other similar arrangements" intended to be within the purview of this requirement.

3. Recommendations

Our recommendations are as follows:

- The Commission should, at a minimum, **exclude** all depositories and foreign sub-custodians and remove the reference to "other similar arrangements" from this aspect of the Proposal.
- If the Commission seeks to implement any rulemaking in this regard, we encourage the Commission to adopt requirements similar to the firmly established and well-functioning standards for registered investment companies under the 1940 Act, which we describe in Section B.1.c above.

C. Indemnification

Our third concern with the Proposal relates to the Commission's efforts to mandate that an adviser obtain assurances in writing from a qualified custodian that the qualified custodian will, among other things, indemnify the client and have in place insurance arrangements that will adequately protect the client against the risk of loss in the event of the qualified custodian's own negligence, recklessness, or willful misconduct.[81] **We urge the Commission to reconsider this requirement as it is both unnecessary given current market practices and overly broad and punitive in terms of its scope and impact.**

1. Current Practice

The role of the bank custodian is based on contractual rights and responsibilities.[82] Banks provide custody services to a variety of customers, including mutual funds and investment managers, retirement plans, bank fiduciary and agency accounts, bank marketable securities accounts, insurance companies, corporations, endowments and foundations.[83] Bank custodians make available a broad range of services that include income collection, processing corporate actions, applying for tax relief from foreign governments on behalf of customers, foreign exchange services to facilitate settlement of cross-border securities transactions, collateral management, securities lending,[84] recordkeeping and reporting services (which can be customized to meet customers' specialized needs)[85] and other "value-added" services like performance measurement and risk management tools.[86] Because services may vary based on the specific needs of a customer, the contractual framework is essential to the operational model and cost structure of the bank custodian's relationship with its customers.

Bank custodians already enter into written agreements directly with its customers and, as the Commission recognized in the Proposal, those agreements provide legal recourse to customers for "losses arising out of or in connection with the custodian's execution or performance under the agreement to the extent the loss is caused by, among other things, the custodian's negligence, gross negligence, bad-faith, recklessness, or willful misconduct."[87] In this way, a customer has direct privity of contract with the bank custodian and therefore the legal right to recover any losses from the custodian to the extent arising from the custodian's failure to perform its obligations in accordance with the standard of care under the agreement.

2. Concerns with the Proposal's Requirements

We have substantive and procedural concerns with this aspect of the Proposal. Substantively, we are concerned that the Proposal conflates the fundamental and critically important legal distinction between contractual liability and indemnification.[88] By virtue of the obligations defined within the contract and applicable state law governing the contract, a bank custodian is already directly liable to its customer for

a failure to perform the agreed-upon responsibilities or fulfill an obligation in accordance with the terms and conditions of the agreement, including the exercise of the required standard of care. An indemnity, however, is traditionally understood to additionally protect another party from third-party claims.[89] Parties to a contract use a contractual indemnity provision to customize risk allocation, which involve any number of negotiated terms and often include obligations to defend indemnified claims and the right of the indemnified party to settle claims.[90] Requiring bank custodians to accept new liabilities and/or indemnification obligations would shift significant risks from investors and investment advisers to their custodians, even when those risks are beyond the control of the custodial bank; *e.g.*, risks that are intrinsic to investing in the securities markets.

Procedurally, we are concerned that the Commission has not sufficiently analyzed or substantiated a need for this requirement, nor has it adequately considered the full breadth of implications resulting from such a broad requirement on qualified custodians.[91] By its own terms, the Commission acknowledges that "the custodial marketplace reflects a broad range of contractual limitations on the qualified custodian's liability to its customers."[92] But, the Proposal appears to supplant well-developed market practices and existing nuances of a bank's contractual liability for custody services with a broad indemnification obligation. We believe that doing so will have significant negative impacts for qualified custodians, investment advisers and ultimately, their clients. The Proposal is silent on these consequences.

Any indemnification requirement, particularly one so broadly imposed, would reflect a substantial increase in potential bank custodian liability and therefore a substantial increase in the cost of providing custody services to investment adviser clients. Global custodians, which the Commission itself admits are already subject to shrinking profit margins,[93] are not compensated to protect their clients from and against any and all third-party claims. Forcing custodians to not only assume liability risk but essentially guarantee or protect their custody clients against virtually any potential claims related to their conduct would dramatically and unnecessarily increase the costs of providing their services—costs which are likely to be passed on directly to the very investors the Proposal seeks to protect.

3. Recommendations

Our recommendations are as follows:

- The Commission should articulate the fundamental distinction between liability and an indemnity. In doing so, we urge the Commission to clarify that an investment adviser must obtain assurances in writing that the custodian is *directly liable* to its client.
- The Commission should clarify that an investment adviser must obtain assurances in writing that the custodian will indemnify the client only if the custodian is not contractually liable to its client for its failure to fulfill its obligations in accordance with the terms and conditions of the written agreement, including the exercise of the required standard of care.

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D. Limitations of Advisory Authority

Our fourth concern with the Proposal relates to the requirement that a written agreement with the qualified custodian include provisions that require the qualified custodian to manage and police an adviser's level of authority to instruct it in respect of transactions in the custodial account. As outlined in Part I, bank custodians are not gatekeepers, and we are concerned about the impact on operating models, existing processes, and the ability to technologically support the requirement. **It is the investor who is best positioned to monitor the transactional activity of its assets managed by an investment manager, and we urge the Commission to consider alternatives that instead provide the investor with enhanced reporting.**

1. Current Practice

We agree with the Commission insofar as client assets are transferred from custodial accounts subject to the bank's receipt of authenticated and authorized instructions. Common industry practice is for a custodian to receive an authorized persons list at the outset of a relationship with a new client. The list of authorized persons sets forth the individuals from whom the custodian may take instructions in various acceptable formats and delivered through various approved mediums. The authorized person list is capable of being updated by clients at such frequencies as the client requires in order to add or remove personnel. Crucially, the authorized signatory list permits the orderly operation of a client's account. Moreover, authorized signatories are, if elected by the client, issued credentials to use proprietary electronic instruction solutions which are designed to use login credentials to expedite the processing of authenticated instructions. The foregoing processes are combined with standard practices such as call-backs to client representatives in connection with cash movements so as to be consistent with the Commission's stated goal of mitigating the risk of rogue advisory employees and misappropriation of client assets.[94]

2. Concerns with the Proposal's Requirements

The Proposal's contemplated changes have received focused and thorough consideration by bank custodians since the Commission released its Inadvertent Custody guidance in 2017. Moreover, this issue has been under intense scrutiny as firms consider how to plan and develop solutions to support and comply with Rule 15c6-1 of the Exchange Act to settle trades one business day after the trade date ("**T+1**"). Custodians are under immense pressure from clients and other market participants to automate instruction processing (*e.g.*, straight-through processing) and reduce or eliminate any manual instruction processing (which can lead to errors). In fact, the Commission itself has stated in the adopting release for T+1:

> In particular, the Commission believes that eliminating the use of tools that encourage or require manual processing, alongside the continued development and implementation of more efficient automated systems in the institutional trade processing environment, is essential to reducing risk and costs to ensure the prompt and accurate clearance and settlement of securities transactions.[95]

The Proposal's allocation of oversight responsibility to not only ensure properly authenticated instructions are processed but to also determine the instruction is within an adviser's scope of authority is seemingly incompatible with the Commission's desire to move to straight-through processing.

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Furthermore, and while efforts are underway to achieve a more efficient settlement process, and, by extension, the development of straight-through processing technologies, this component of the Proposal severely jeopardizes the ability of both advisers and their qualified custodians to comply with all rules and regulations applicable to market participants. Accordingly, we believe this component of the Proposal, if adopted, will severely hinder the ability to support T+1 and will likely result in both (i) the delay or failure of a virtually unquantifiable number of trades to which qualified custodians and advisers are parties, and (ii) a significant increase in market participants needing to avail themselves to section (a) and (b) of Rule 15c6-1.

The Proposal's adviser authority requirement will significantly impact the ability of custodians, broker-dealers, advisers and ultimately, investors, to satisfy other Commission rules including, but not limited to, new Rules 15c6-1 and 17Ad-27. This component of the Proposal would result in the custodian being obligated to actively monitor the millions of instructions received on a daily basis. Processing of instructions, even if currently delivered through a straight-through processing medium, will become manual. All instructions would, essentially, be paused at the custodian so that it could perform a check as to whether or not each individual instruction is within that particular adviser's scope of authority. This creates an inherently manual processing environment which injects more risk into the settlement process and is contrary to the stated objectives of the Commission in respect of its desire to foster broader use of straight-through processes.

Finally, the custodial banking framework has long been premised on the custodian promptly and confidently acting on authorized instructions. The Proposal would fundamentally alter how custodial services are delivered and consumed as custodians would be required to perform subjective analysis in connection with all instructions that must be processed (requiring custodians to act in a quasi-fiduciary capacity). Custodial banks and their personnel do not have the requisite expertise and training the Proposal requires in order to properly discharge these obligations. Custodial banks, as a matter of course, do not even engage in an objective analysis of investment guideline monitoring much less subject authority related questions. Investment oversight and monitoring is simply not a function a custodial bank is positioned to support. On the other hand, investors, particularly institutional investors, regularly perform due diligence on their investment fiduciaries, and often employ personnel devoted to the oversight and monitoring of their adviser's compliance and activities. Investors and their consultants and staff are best poised to monitor the activities of the investment adviser and engage directly with the adviser to ensure compliance with the mandate set forth in the advisory agreement.

3. Recommendations

We continue to believe in what has been a foundational premise of the Custody Rule since 2009—that it is the investor who is best positioned to monitor the transactional activity of its assets managed by an investment adviser. We therefore recommend:

- The Commission consider, as alternatives, certain reporting enhancements and other objective and data driven solutions such as real-time cash reporting, real-time transactional reporting, or push notifications to clients each time a transaction is processed through the custody account.

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Part III – Concerns Related to Digital Asset Custody

This part describes our views and concerns with the Proposal as it relates to bank custodians' ability to act as a qualified custodian for digital assets.

The Proposal expands in-scope assets from "client funds and securities" under the existing Custody Rule to "funds, securities, *or other positions held in a client's account*"—the expansion of which encompasses digital assets.[96] Therefore, the same general requirements in the Proposal that must be satisfied in order for a custodian to be a qualified custodian for traditional assets (*e.g.,* holding assets in a segregated and bankruptcy remote manner) *also apply* in order for a custodian to be a qualified custodian for digital assets. By expanding the scope to include digital assets, and subjecting traditional and digital assets to the same general requirements, the Commission acknowledges that it is employing an "asset neutral approach."[97] Indeed, the Commission states as follows in the Proposal: "While we agree that custodial activities may differ between traditional assets and crypto assets, we believe that the asset neutral approach of the current rule has been and will continue to be more effective because it relies on the expertise of the various types of qualified custodians and allows the rule to remain evergreen as the types of assets held by custodians evolve."[98]

We agree with the above for the following reasons:

- The Commission is correct in relying on the expertise of custodians to expand their custodial services to include digital assets. The Commission is also correct in stating that "this is not the first time custodians have had to adapt their practices to safeguard different types of assets" because custodians have a "long history of developing different procedures for safeguarding a variety of assets."[99] In October 2022, we launched our Digital Asset Custody ("**DAC**") platform that expands our custodial services by allowing select U.S.-based institutional clients to custody with us their bitcoin or ether.[100] We view our DAC platform as a natural evolution of our custodial business, and DAC was developed based on the knowledge and expertise gained from serving as the world's largest custodian; there are foundational custodial principles that apply irrespective of whether the custodied asset is a traditional or digital asset. As a result, we appreciate the Commission's recognition of the innovative roles custodians have played—and will continue to play—in safeguarding assets that leverage new technologies such as distributed ledger technology ("**DLT**").

- We believe that the Proposal's articulation of the requirements a custodian must meet in order to serve as a qualified custodian for digital assets is a positive development and substantively addresses the underlying concerns SAB 121 sought to resolve. While affected entities may debate those requirements, setting forth the "rules of the road" is an important and welcomed threshold step. As to the requirements more specifically, we agree that holding digital assets in a segregated and bankruptcy remote manner is important—our DAC platform already does so. We do, however, have concerns—*e.g.,* the same concerns about the scope of indemnification for traditional assets also apply here. We defer to the arguments presented in the trade association responses on the specifics of these requirements in the interest of brevity and to maintain our thematic views.[101]

- We also agree with the Commission's stated "asset neutral approach" as it relates to non-cash assets. We provide a wide portfolio of services for traditional assets to clients across our Asset Servicing and other lines of businesses, and we naturally seek for those services to include digital assets.

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Despite our thematic agreements here, we do have an overarching concern: the Commission's pro innovation and asset neutral views in the Proposal are in direct conflict to the limiting and asset specific approach in SAB 121. Except for one footnote in a multi-hundred-page document,[102] the Proposal does not substantively address SAB 121 or otherwise attempt to resolve this conflict. That is problematic. **We believe it is imperative that the Commission resolve this conflict by providing a bank qualified custodian exemption to the on-balance sheet requirement of SAB 121.**

A. Conflict with SAB 121 Requiring Resolution

When developing our DAC platform, we operated under the belief that this long-standing approach to custodying assets like securities on an off-balance sheet basis would similarly apply to custodying digital assets. As stated by Jerome Powell, Chair of the Federal Reserve Board of Governors, "custody assets are off balance sheet, have always been."[103] SAB 121 changed that. SAB 121 requires custodied digital assets to be reflected on the custodian's balance sheet by *creating* and recording both (i) a liability regarding the custodian's safeguarding obligation and (ii) a corresponding safeguarding asset (which is distinct from the underlying actual digital asset).[104] Through SAB 121, the Commission takes an asset-specific approach as to how custodians are to account for an asset class (digital assets), meaning that custodied traditional assets are accounted for one way (off balance sheet), but custodied digital assets are accounted for another way (on balance sheet) notwithstanding that the custodian does not own, nor maintain any contractual or economic rights or risks of ownership with respect to, these digital assets. It is therefore contradictory for the Commission, one year later, to articulate in the Proposal an asset-neutral approach for traditional and digital assets.

Requiring banks to place on their balance sheet custodied assets that they do not own has significant implications and is distortive to their financial statements. As outlined in detail in trade association[105] and even Congressional letters in response to SAB 121,[106] banks have capital, liquidity and other prudential requirements that non-bank custodians do not have. Placing assets on balance sheet impacts those requirements and results in capital and liquidity charges, which are prohibitive. Thus, as a practical matter, banks cannot conduct digital asset activities at scale due to the balance sheet impact of SAB 121. To illustrate, BNY Mellon has $46.6 trillion in AUC/A. Even if we sought to custody digital assets **at only 1% of that figure**, $466 billion, we could not do so because of SAB 121—in that hypothetical, SAB 121 would require us to put $466 billion on our balance sheet (*more than doubling it*), and we would therefore breach various prudential requirements.

SAB 121 is problematic for multiple reasons. If banks cannot provide digital asset custody services at scale, they will likely not offer those services. This means that market participants will not have bank-grade custody solutions to pick from and may turn to off-shore solutions, diminishing American competitiveness. Further, SAB 121 is broad in that it captures any "digital asset that is issued and/or transferred using distributed ledger or blockchain technology using cryptographic techniques."[107] In addition to cryptocurrencies like bitcoin and ether, this also facially covers tokenized assets. Tokenized assets have the potential to provide operational efficiencies and enhanced liquidity to the global markets,[108] but SAB 121 similarly curbs banks' ability to innovate with other DLT use cases outside of cryptocurrencies.

For the reasons stated above, SAB 121 is a threshold issue for banks and one that we can offer first-hand knowledge of given our live DAC platform. Requiring banks to place custodied digital assets on balance sheet undercuts all of the previously-described benefits of the Proposal as it relates to digital assets. In practice, this means that very few banks will actually seek to satisfy the requirements in the Proposal to

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become a qualified custodian for digital assets; even if they do, they will not be able to provide digital asset custody services at any meaningful scale.

B. Recommendations

The Commission should modify either the Proposal or SAB 121 itself to exempt qualified bank custodians from the on-balance sheet requirement of SAB 121 (Interpretive Question No. 1 in SAB 121). Many of the underlying concerns that SAB 121 is premised on are addressed by the Proposal's articulation of the requirements to be a qualified custodian (*e.g.,* holding assets in a segregated and bankruptcy remote manner). Providing this exemption will promote the pro-innovation and asset neutral approach of the Proposal, will resolve the conflict between the Proposal and SAB 121, and is consistent with other instances where safeguarding activities conducted by banking organizations are exempt from additional regulation by the Commission.[109]

Conclusion

BNY Mellon appreciates the Commission's consideration of the views and recommendations expressed in this Response. We look forward to further engagement with the Commission on these topics.

Sincerely,

Roman Regelman
CEO of Securities Services and Digital
BNY Mellon

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APPENDIX – SUMMARY OF BNY MELLON RESPONSE

Areas	Five Topics of Concern	Reasons for Concern	Recommendations for Consideration
Traditional Custody	**(1) New requirements a bank must satisfy to be a qualified custodian (“QC”), specifically, holding client assets in segregated, bankruptcy remote accounts**	• The Proposal’s segregation requirement does not distinguish client cash from client securities and other non-cash assets • Requiring banks to hold client cash off-balance sheet in segregated, bankruptcy-protected accounts is a fundamental shift in practice; banks hold cash on balance sheet as a deposit liability • Holding client cash as required by the Proposal could “lock up” cash and lead to increased costs and/or lost income for end clients	• Client cash should be excluded from the segregation requirement • The Commission should provide a framework that would require disclosure documents be provided to clients which set forth how cash balances are treated and the protections cash may (or may not) be afforded
	(2) New requirement that QCs not be excused from its obligations to the client as a result of any sub-custodial, securities depository, or other similar arrangements	• The Proposal disregards structural differences between depositories and sub-custodians. In particular, use of a securities depository is a consequence of an investor’s decision to invest in securities in a particular market that are immobilized in that depository. There is little or no element of choice on the part of the custodian • Regarding foreign sub-custodians, the Proposal makes no distinction between custodial risk, which would largely be based on the sub-custodian in a foreign investment market, and all other systemic, geopolitical, economic, structural and market risks that exists regardless of the level of care that is provided by a custodian in that market	• The Commission should exclude all depositories and foreign sub-custodians from this requirement • The Commission should remove the reference to “other similar arrangements” • In the alternative, the Commission should adopt requirements similar to standards set for registered investment companies
	(3) New requirement that QCs indemnify the client against losses caused by the QC’s negligence, recklessness, or willful misconduct	• The Proposal conflates the fundamental legal distinction between contractual liability and indemnification • The new indemnification requirement would reflect a substantial increase in potential bank custodian liability and therefore a substantial increase in the cost of providing custody services to investment adviser clients	• The Commission should clarify that an RIA must obtain reasonable assurances in writing that the custodian is *directly liable* to its client • The Commission should clarify that an investment adviser must obtain assurances in writing that the custodian will indemnify the client only if the custodian is not contractually liable to its client for its failure to fulfill its obligations in accordance with the terms and conditions of the written agreement, including the exercise of the required standard of care
	(4) New written agreement requirement between the adviser and QC, specifying the adviser’s level of authority	• It is the investor who is best positioned to monitor the transactional activity of its assets managed by an investment manager • This requirement will severely hinder the ability to support T+1 and lead to slower processing times for clients	• The Commission should consider, as alternatives, certain reporting enhancements and other objective and data-driven solutions to allow clients to monitor transactions in their account
Digital Asset Custody	**(5) The Proposal is silent on SEC Staff Accounting Bulletin No. 121 (“SAB 121”)**	• Articulating the requirements for banks to be QCs for digital assets is hypothetical because SAB 121 prevents banks from engaging in this activity at scale	• The Commission should exempt bank QCs from the on-balance sheet requirement of SAB 121

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[1] *See* Safeguarding Advisory Client Assets, Investment Advisers Act Release No. 6240, 88 Fed. Reg. 14672 (proposed Mar. 9, 2023) [hereinafter Proposal], *available at* https://www.federalregister.gov/documents/2023/03/09/2023-03681/safeguarding-advisory-client-assets.
[2] Financial Stability Board, *2022 List of Global Systemically Important Banks* (G-SIBs) (Nov. 21. 2022), *available at* https://www.fsb.org/wp-content/uploads/P211122.pdf.
[3] Press Release, BNY Mellon, BNY Mellon Reports First Quarter 2023 Earnings of $905 Million or $1.12 Per Common Share (Apr. 18, 2023), *available at* https://www.bnymellon.com/content/dam/bnymellon/documents/pdf/investor-relations/earnings-press-release-april-2023.pdf.coredownload.pdf.
[4] Bank of New York Mellon Corp., Annual Report to Security Holders (Form ARS) (Mar. 1, 2023) [hereinafter Annual Report], *available at* https://www.sec.gov/Archives/edgar/data/1390777/000119312523055117/d410581dars.pdf.
[5] *See* Comment Letters filed: (i) jointly by the American Bankers Association, Bank Policy Institute and Financial Services Forum; (ii) by the Association of Global Custodians; (iii) by the Securities Industry and Financial Markets Association [hereinafter SIFMA Response]; and (iv) by the Investment Company Institute [collectively, hereinafter Industry Trade Association Responses].
[6] *Id.* at 14673.
[7] Proposal at 14691, 14745.
[8] SEC, What We Do, https://www.sec.gov/about/what-we-do (last modified Apr. 6,2023).
[9] Proposal at 14756, 14757.
[10] *See* discussion of impact and economic analyses and concerns raised in Industry Trade Association Responses *supra* note 5.
[11] For purposes of this Response, the term "digital assets" is ascribed the same meaning as used by the Bank for International Settlements. *See* Basel Committee on Banking Supervision, *Prudential Treatment of Cryptoasset Exposures* (Dec. 2022), *available at* https://www.bis.org/bcbs/publ/d545.pdf (defining digital assets as "a digital representation in value which can be used for payment or investment purposes or to access a good or service. This does not include digital representations of fiat currencies.").
[12] *See* Proposal at 14736-37.
[13] *See* FDIC, *Options for Deposit Insurance Reform* (May 1, 2023), *available at* https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-full.pdf.
[14] Press Release, SEC, SEC Reopens Comment Period for Proposed Amendments to Exchange Act Rule 3b-16 and Provides Supplemental Information (Apr. 14, 2023), *available at* https://www.sec.gov/news/press-release/2023-77.
[15] Press Release, SEC, SEC Reopens Comment Period for Proposed Amendments to Modernize Beneficial Ownership Reporting (April 28, 2023), *available* at https://www.sec.gov/news/press-release/2023-83.
[16] *See* Industry Trade Association Responses *supra* note 5.
[17] Proposal at 14682-83.
[18] Proposed Rule 223-1(d)(10).
[19] Proposal at 14683.
[20] *Id.* at 14693.
[21] *Id.* at 14678-79.
[22] Proposal at 14742.
[23] The Clearing House, Custody Services of Banks at 4 (July 2016) [hereinafter Custody Services of Banks], *available at* https://www.theclearinghouse.org/-/media/tch/documents/research/articles/2016/07/20160728_tch_white_paper_the_custody_services_of_banks.pdf; *see also* Office of the Comptroller of Currency, Custody Services Handbook at 2 (January 2002) [hereinafter OCC

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Handbook], *available at* https://www.occ.gov/publications-and-resources/publications/comptrollers-handbook/files/custody-services/pub-ch-custody-services.pdf (noting that "[s]ervices provided by a bank custodian are typically the settlement, safekeeping, and reporting of customers' marketable securities and cash").
[24] Custody Services of Banks at 3-4; OCC Handbook at 14; Office of the Comptroller of the Currency, Interpretive Letter #1170, Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers at 6 (July 22, 2020), *available at* https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1170.pdf.
[25] BNY Mellon launched its digital asset custody platform in October 2022. *See* Press Release, BNY Mellon, BNY Mellon Launches New Digital Asset Custody Platform (Oct. 11, 2022), *available at* https://www.bnymellon.com/us/en/about-us/newsroom/press-release/bny-mellon-launches-new-digital-asset-custody-platform-130305.html.
[26] MARC LABONTE AND DAVID W. PERKINS, CONG. RSCH. SERV., IF11055, INTRODUCTION TO BANK REGULATION: SUPERVISION 2 (2018).
[27] *See, e.g.,* Proposal at 14675, 14694.
[28] Custody Services of Banks at iii.
[29] *Id.* at 9.
[30] *Id.* at iii.
[31] *Id.* at ii, 1.
[32] OCC Handbook at 1.
[33] Proposal at 14675, 14682.
[34] *Id.* at 14682.
[35] *Id.* at 14683.
[36] Custody Services of Banks at 4.
[37] *Id.* at 20.
[38] *Id.* At 21.
[39] *Id.* at 21. This difference in treatment drives phraseology. It is accurate to state that bank custodians "custody" client securities and other non-cash assets—"custody" meaning held on an off-balance sheet basis because the bank custodian does not own those assets and cannot use them. However, it is inaccurate to state that bank custodians similarly "custody" cash. That is because, in comparison, client cash is held on balance sheet (*e.g.,* as a deposit liability) as the client cash becomes the bank's property and the bank can, in turn, use that cash for operational purposes. Stated differently, there is no such concept as a bank custodian "custodying cash."
[40] 2022 Annual Report at II.
[41] BNY Mellon, Financial Supplement First Quarter 2023, *available at* https://www.bnymellon.com/content/dam/bnymellon/documents/pdf/investor-relations/financial-supplement-1q-2023.pdf.coredownload.pdf.
[42] ANDREW P. SCOTT & MARC LABONTE, CONG. RSCH. SERV., R47447, BANK CAPITAL REQUIREMENTS: A PRIMER AND POLICY ISSUES 7, 15 (Mar. 9, 2023).
[43] Our bank subsidiaries are subject to similar capital requirements administered by the Federal Reserve in the case of The Bank of New York Mellon and by the OCC in the case of our national bank subsidiaries, BNY Mellon, N.A. and The Bank of New York Mellon Trust Company, National Association.
[44] *See generally* MARC LABONTE, CONG. RSCH. SERV., R45711, ENHANCED PRUDENTIAL REGULATION OF LARGE BANKS (May 6, 2019).
[45] Proposal at 14683.
[46] *See* Industry Trade Association Responses *supra* note 5.
[47] Proposal at 14683, n.93.
[48] *See* Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 70072, 78 Fed. Reg. 51823, 51825 (Aug. 21, 2013) (codified at 17 C.F.R. § 240.15c3-3) [hereinafter Rule 15c3-3 Release].
[49] Proposal at 14695, n.171.

BNY MELLON

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[50] Rule 15c3-3 Release at 51832 (emphasis added).
[51] Capital, Margin and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers, Exchange Act Release No. 86175, 84 Fed. Reg. 43872, 43940 (Jun. 21, 2019) (citing the Federal Reserve's recognition "that deposits are the primary funding source for most banks and that banks use deposits in a variety of ways, primarily to fund loans and investments"). *See also* Federal Reserve, Division of Banking Supervision and Regulation, Commercial Bank Examination Manual, Section 3000.1, Deposit Accounts *available at* http://www.federalreserve.gov/boarddocs/supmanual/cbem/3000.pdf.
[52] Investment Advisers Act of 1940 § 202(c), 15 U.S.C. § 80b-2(c).
[53] By way of example, we urge the Commission to consider (i) inserting "(other than cash)" after "client assets" in paragraph (d)(10)(i) of the Proposed Rule and (ii) amending paragraph (a)(1)(ii)(D) to expressly exclude qualified custodians as defined in paragraph (d)(10)(i) of the Proposed Rule.
[54] We urge the Commission to consider disclosure similar to how the "banking exemption" is applied in the United Kingdom to deposit taking banks. The exemption requires that clients be notified that (a) money held for clients is held by the firm as banker and not as a trustee under the client money rules; and (b) if the bank fails, the client money distribution and transfer rules will not apply to these sums and so the client will not be entitled to share in any distribution under the client money and transfer rules. This notification is commonly included in the bank's terms and conditions. *See* The Investing and Saving Alliance, CASS Best Practice Guide (September 2020) *available at* https://www.tisa.uk.com/wp-content/uploads/2020/12/TISA-Combined-CASS-Best-Practice-Guide-v1.3-Oct-2020.pdf.
[55] SEC, Our Goals, https://www.sec.gov/our-goals (last modified April 6, 2023).
[56] Proposed Rule 223-1(a)(1)(ii)(C). According to the Proposal, the Commission believes that this requirement "would help reduce the ability of a qualified custodian to avoid responsibility for the other important safeguarding obligations it has to the advisory client by delegating custodial responsibility to a sub-custodian, securities depository, or other similar arrangements." Proposal at 14695.
[57] Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 23815, 64 Fed. Reg. 24489, 24490-91 (May 6, 1999) [hereinafter Rule 17f-7 Proposing Release] (observing "[y]et a securities depository also may be an instrumentality of a foreign government or market and may operate under an exclusive license, making its use practically (and perhaps legally) necessary for a fund that wishes to invest in a particular foreign market").
[58] OCC Handbook at 20.
[59] *Id.* at 13.
[60] *Id.*
[61] *See generally* Investment Company Act of 1940 § 17(f), 15 U.S.C. § 80a-17(f). We recognize that the Proposed Rule would not apply to the account of any investment company registered under the 1940 Act. *See* Proposed Rule 223-1(b)(2). However, we believe that Section 17(f) of the 1940 Act and Rules 17f-1 through 17f-7 thereunder are instructive here, as this regime has functioned exceptionally well in protecting assets for the benefit of fund investors.
[62] Section 17(f) is intended to prevent fund insiders and affiliates from misappropriating fund assets. *See* 15 U.S.C. § 80a-17(f).
[63] 17 C.F.R. § 270.17f-4.
[64] The rule imposes certain basic requirements on an acceptable eligible securities depository. *See* 17 C.F.R. § 270.17f-7.
[65] *Id.*
[66] Proposal at 14673.
[67] Rule 17f-7 Proposing Release at 24492-93.
[68] Rule 17f-5 was adopted in 1984, and extensively revised in 1997 to expand the types of foreign banks and securities depositories that may serve as custodians of fund assets, and required that the selection of a foreign

custodian be based on whether the fund's assets will be subject to reasonable care if maintained with that custodian. In 1998, as a result of difficulties experienced by funds, their advisers and bank custodians in applying the standards of Rule 17f-5 to the use of foreign depositories, the Commission suspended the compliance date for most of the 1997 Amendments. Representatives of funds and bank custodians then submitted a proposal to further amend Rule 17f-5 to change the standards by which foreign depositories are evaluated.

[69] Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 22658, 62 Fed. Reg. 26923, 26925 (May 12, 1997) [hereinafter Rule 17f-5 Amendments Adopting Release].

[70] Rule 17f-7 Proposing Release at 24490-91.

[71] Referring to proposed amendments to Rule 17f-5, the Commission acknowledged that "[t]hroughout the rulemaking, the Commission made it clear that we considered foreign depositories to be custodians for purposes of the rule [17f-5 amendments in 1997]" but that "[b]y early 1998, it became apparent that the rule would not operate as anticipated." Rule 17f-7 Proposing Release at 24490.

[72] Proposal at 14695 (depository as a "third party *selected* by the qualified custodian").

[73] *Id.* (depository as a "third-party it *hires*").

[74] *Id.* (describing use of a depository as a *delegation* by a qualified custodian).

[75] *Id.* (discussing concerns over *outsourcing* in the "custodial space").

[76] Rule 17f-5 Amendments Adopting Release at 26925.

[77] *Id.* at 26924-26.

[78] Rule 17f-7 Proposing Release at 24490.

[79] Rule 17f-5 Amendments Adopting Release at 26926.

[80] Proposed Rule 223-1(a)(1)(ii)(C) (emphasis added).

[81] Proposed Rule 223-1(a)(1)(ii)(B).

[82] *See* discussion *supra* Part I; *see also* OCC Handbook at 1.

[83] *Id*.

[84] OCC Handbook at 23.

[85] *Id.* at 21.

[86] *Id.* at 37.

[87] Proposal at 14694.

[88] A separate requirement of the Proposal would mandate that the custodian "will exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and will implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar type of loss." Proposed Rule 223-1(a)(1)(ii)(A).

[89] Negotiating Indemnity, ABA Practice Points (May 5, 2017), *available at* https://www.americanbar.org/groups/litigation/committees/corporate-counsel/practice/2017/negotiating-indemnity/.

[90] In New York, for example, the right to contractual indemnification is guided by the specific language of the contract. *See., e.g.*, *DiBuono v. Abbey, LLC*, 944 N.Y.S.2d 280, 285 (2d Dep't 2012).

[91] It bears noting that, other than discussing certain staff observations in the Proposal, the Commission concludes this requirement is needed based exclusively on one legal scholar's mention of custodial misconduct as one of "at least four risks that can undercut if not eliminate the protections of a custody account" in an article discussing *institutional* investors. Proposal at 14694 citing Edward H. Klees, *How Safe Are Institutional Assets in a Custodial Bank's Insolvency*, 68 BUS. LAW. 103, 106 (2012) (in which the author explains that such risk is "even more acute concern in the wake of MF Global which, *though not a bank*, highlights the risk of negligence)(emphasis added).

[92] Proposal at 14694.

[93] *Id.* at 14739.

[94] *Id.* at 14699 (indicating the Commission is concerned that a "rogue advisory employee misuses the authority to direct the disposition of a client's assets held by the custodian").

BNY MELLON

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[95] Shortening the Securities Transaction Settlement, Exchange Act Release No. 94196, Advisers Act Release No. 5957, 87 Fed. Reg. 10436, 10458 (Feb. 24, 2022).
[96] Proposal at 14678-79.
[97] *Id.* at 14691.
[98] *Id.* at 14692.
[99] *Id.*
[100] Press Release, BNY Mellon, BNY Mellon Launches New Digital Asset Custody Platform (Oct. 11, 2022), *available at* https://www.bnymellon.com/us/en/about-us/newsroom/press-release/bny-mellon-launches-new-digital-asset-custody-platform-130305.html.
[101] *See* SIFMA Response *supra* note 5. In addition to SAB 121 and indemnification, the digital asset section of the SIFMA Response also addresses concerns including but not limited to the Special Purpose Broker Dealer Safe Harbor, digital asset taxonomies and DLT configurations, sub-custodial liabilities, possession or control, and insurance and audit requirements. *Id.*
[102] Proposal at 14676, n.27.
[103] Jesse Hamilton, *US Fed Evaluating SEC's Position on Digital Assets Custody,* CoinDesk (June 22, 2022 at 4:09 p.m.), https://www.coindesk.com/policy/2022/06/22/us-fed-evaluating-secs-position-on-digital-assets-custody-powell-says/.
[104] SEC Staff Accounting Bulletin No. 121 (Apr. 11, 2022) [hereinafter SAB 121], *available at* https://www.sec.gov/oca/staff-accounting-bulletin-121.
[105] *See, e.g.,* American Bankers Association, Bank Policy Institute and the Securities Industry and Financial Markets Association, Joint Trades Letter on Staff Accounting Bulletin No. 121 Issued by the Staff of the Office of the Chief Accountant of the Securities and Exchange Commission (June 23, 2022) [hereinafter Joint Trades Letter], *available at* https://www.aba.com/-/media/documents/comment-letter/joint-trades-letter-on-sec-sab-121-06232022.pdf?rev=2df24025cc9d4763a76627bbfcd3cec7.
[106] *See, e.g.,* House Financial Services Committee Chairman Patrick McHenry (R-NC-10) & U.S. Senator Cynthia Lummis (R-WY), Letter Regarding Prudential Impact of Staff Accounting Bulletin 121 (Mar. 2, 2023), available at https://www.lummis.senate.gov/wp-content/uploads/Prudential-Impact-of-SAB-121-Letter.pdf.
[107] SAB 121 at n.3.
[108] *See* BNY Mellon, BNY Mellon Digital Asset Survey (2022), *available at* https://www.bnymellon.com/us/en/insights/all-insights/digital-asset-survey.html.
[109] Joint Trades Letter at 16.